The Bankler Report

November 6, 2017

INTRODUCTION

On November 2, the U.S. House of Representatives released the draft legislative language to H.R. 1 "Tax Cuts and Jobs Act." The following is a summary of the major provisions of the bill (unless otherwise noted, all provisions are for taxable years beginning after 2017):

Business Provisions:

1. **Flat Corporate Tax Rate** -The bill would replace the current four-tier schedule of corporate rates (15%, 25%, 34%, and 35%, with a $75,001 threshold for the 34% rate) with a flat 20% rate (25% for personal services corporations). The corporate alternative minimum tax (AMT) is repealed along with the individual AMT.
2. **Pass-Thru Business Tax Rate** - The bill creates a unified maximum "business tax rate" of 25% on "Qualified Business Income" for the owners of S corporations, partnerships and sole proprietorships. Basically this 25% rate applies to **ALL** of the net income reported by **PASSIVE** investors of the business. Owners who "materially participate" in the business default to having 70% of the income taxed at regular rates, with only 30% of the income subject to the 25% business rate. These owners, however, may use a formula to establish, based on the "facts and circumstances" of their particular business, that more than 30% of the income from the business was attributable to capital and should be taxed at 25%. However, **service business owners**, such as accountants and lawyers, have the presumption that **none of the income is subject to the 25%** rate, but again, these owners can elect to apply a formula to justify a higher percentage.
3. **Expensing of Asset Acquisitions** – Instead of bonus deprecation, taxpayers would be able to fully and immediately expense 100% of the cost of qualified property, with a useful life of 20 years or less, acquired and **placed in service after Sept. 27, 2017,** and before Jan. 1, 2023. Properties used by regulated public utilities or used in a real property trade or business are excluded.
4. **Code Sec. 179 Expensing** – Small business expensing of qualified property would be increased to $5 million (from the current $500,000), and the phase-out amount would be increased to $20 million (from the current $2 million), effective for tax years beginning after 2017 through tax years beginning before 2023. Both amounts would be indexed for inflation. The definition of section 179 property would also include qualified energy efficient heating and air-conditioning property permanently, **effective for property acquired and placed in service after Nov. 2, 2017.**
5. **Small Business Accounting Reforms.**
   a. Cash Method of Accounting – Currently small businesses may only use the cash method of accounting if average gross receipts do not exceed $5 million for all prior years. This bill raises the gross receipts test to $25 million and the requirement that such businesses satisfy the requirement for all prior years would be repealed. In addition, businesses with inventories now qualify.
   b. Long-Term Contracts – Non-residential construction contractors will now be allowed to use the completed contract method (instead of the required percentage of completion method) if their average gross receipts is $25 million, up from $10 million. Residential contractors may be exempt from the percentage of completion method. In addition, Congress is not changing the Tax Court's decision in Shea Homes, Inc.
6. **Like-kind Exchanges** – The current rules will apply, except it will only be allowed for real estate.

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7. **Meals & Entertainment** - The 50% limitation under current law would apply **only to expenses for food or beverages and to qualifying business meals**, with no deduction allowed for other entertainment expenses. Therefore, no deduction would be allowed for entertainment, amusement or recreation activities, facilities, or membership dues relating to such activities or other social purposes. In addition, no deduction would be allowed for transportation fringe benefits, benefits in the form of on-premises gyms and other athletic facilities, or for amenities provided to an employee that are primarily personal in nature and that involve property or services not directly related to the employer's trade or business.
8. **Qualified Production Activity Deduction** – The 9% deduction allowed for these activities are repealed for tax years beginning after 2017.
9. **Tip Credits for employer portion of social security taxes** – The bill provides that the credit for a portion of the employer social security taxes paid with respect to employee tip income would be modified to reflect the current minimum wage so that it is available with regard to tips reported only above the current minimum wage rather than tips above $5.15 per hour. In addition, all restaurants claiming the credit would be required report to tip allocations among tipped employees (allocations at no less than 10% of gross receipts per tipped employee rather than 8%), which is a reporting requirement now required only of restaurants with at least ten employees.
10. **Net Operating Loss deduction limitation** – The bill provides that taxpayers would be able to deduct a net operating loss (NOL) carryover or carryback only to the extent of 90% of the taxpayer's taxable income (determined without regard to the NOL deduction) rather than the current 100% for small businesses. Deductions eliminated or limited: Deductions of net operating losses (NOLs) would be limited to 90% of taxable income. NOLs would have an indefinite carryforward period, but carrybacks would no longer be available for most businesses. Carryforwards for losses arising after 2017 would be increased by an interest factor.
11. **Interest deduction limitations** – The bill provides that every non-small business (defined in #5 above), regardless of its form, would be subject to a disallowance of a deduction for net interest expense in excess of 30% of the business's adjusted taxable income. Disallowed interest deductions would be carried forward to the succeeding five tax years and would be an attribute of the business (as opposed to its owners).
12. **Self-Created Property not treated as capital asset** - Gain or loss from the disposition of a self-created patent, invention, model or design (whether or not patented), or secret formula or process would be ordinary in character. The election to treat musical compositions and copyrights in musical works as a capital asset would be repealed.

Individual Provisions:

13. **Ordinary Income Tax Rates** -The Bill would reduce the number of tax brackets (ranging from 10% to 39.6%) from seven to four: 12%, 25%, 35%, and 39.6%

Comparison of old versus new rates - single taxpayers:

Income Level	Old Rate	New Rate
$0 – $9,525	10%	12%
$9,526-$38,700	15%	12%
$38,701-$45,000	25%	12%
$45,001-$93,700	25%	25%
$93,701-$195,450	28%	25%
$195,451-$200,000	33%	25%
$200,001-$424,950	33%	35%
$424,951-$426,700	35%	35%
$426,701-$500,000	39.6%	35%
> $500,000	39.6%	39.6%

Married taxpayers filing jointly:

Income Level	Old Rate	New Rate
$0 – $19,050	10%	12%
$19,051-$77,400	15%	12%
$77,401-$90,000	25%	12%
$90,001 – $156,150	25%	25%
$156,151-$237,950	28%	25%
$237,951-$260,000	33%	25%
$260,001-$424,950	33%	35%
$424,951-$480,050	35%	35%
$480,051-$1,000,000	39.6%	35%
> $1,000,000	39.6%	39.6%

The plan retains the "marriage penalty," with the start of the 35% bracket, which begins at $200,000 for single taxpayers but at only $260,000 (rather than $400,000, or an amount twice the single bracket) for married couples.

14. **Long Term Capital Gains Tax Rates** -The bill would apply a 0% capital gains rate to capital gains "below the 15% rate threshold". A 15% bracket would apply to gains below the 20% rate threshold and the 20% rate would apply thereafter.
15. **ACA (ObamaCare) Net Investment Income Taxes** – The 3.8% tax surcharge **has not been repealed!**
16. **Standard Deduction** – The standard deduction has been increased from (single) $6,350 to $12,000 and from (MFJ) $12,700 to $24,000, **but the personal exemptions have been eliminated.**

17. **Deductions** –
    - A. **Eliminated:** Alimony payments, Moving expenses, Contributions to Medical Savings Accounts, Uninsured medical expenses, Personal casualty losses (except for Federal declared disasters), State & Local income taxes, Unreimbursed employee expenses, and Tax preparation fees
    - B. **Modified:** Mortgage Interest deductions limited to $500,000 acquisition of principal residence mortgages. Real property taxes limited to $10,000.

Estate & Gift Provisions.

18. **Exclusion** - The Act would double the base estate exclusion amount from $5 million (as indexed for inflation; $5.6 million for 2018 per taxpayer) to $10 million.
19. **Repeal of Estate Tax** - The bill would repeal both the Estate and Generation Skipping Transfer taxes for taxpayers dying after December 31, 2023, while still maintaining a beneficiary's stepped-up basis in estate property.
20. **Gift Tax** - The bill would lower the gift tax to a maximum rate of 35% for gifts made after December 31, 2023, also retain the basic exclusion amount of $10 million, and an annual exclusion amount of $15,000 (for 2018), as indexed for inflation.

Planning Opportunities.

- A. **Defer income (and/or accelerate deductions) to shift taxable income from 2017 to 2018**. The Bill lowers tax rates for taxable incomes below $1,000,000. In addition, the maximum rate of 39.6% (MFJ) is scheduled to start at $1,000,000 instead of $480,051. At $1,000,000 taxable income, a married filing joint return tax liability will be reduced from $154,845 to $130.318, a reduction of $24,547. HOWEVER the definition of taxable income has been changed and each taxpayer needs to compute their 2018 expected liability.
- B. **Asset Acquisitions** – If you are planning major asset purchases (with useful life of 20 years or less) the next several months (including 2018) you should consider purchasing and PLACING THEM INTO SERVICE on or before December 31, 2017. Careful planning is required as you DO NOT want to completely eliminate your taxable income or create a net operating loss.
- C. **Small Business with Inventories** – Since businesses under $25 million with inventories now qualify for the cash method, these businesses should reduce these inventory levels to as low as possible in 2017 and then rebuild them in 2018.
- D. **Self-created property** – Property described in #12, when disposed after 2017, would no longer be capital gain property. Consider making a disposition (related party?) of this property before the end of 2017.

This report only discusses proposals that we consider to be of general interest to our readers and is not a complete discussion of the bill's contents. It is anticipated that there will be numerous changes and modifications to these proposals in order to attract additional votes. Please feel free to contact us with your specific questions.

FEDERAL INCOME TAX SUMMARY

CLIENT SAMPLE1 BEN AND ANITA CASEY

INCOME	2017	2018
WAGES, SALARIES, TIPS, ETC.	124,200	124,200
INTEREST INCOME.	38	38
BUSINESS INCOME.	6,885	6,885
CAPITAL GAIN OR LOSS.	57	57
FORM 4797 GAINS OR LOSSES.	24	24
TAXABLE IRA DISTRIBUTIONS.	396	396
RENT, ROYALTY, PARTNERSHIP, SCORP, TRUST.	61,833	61,833
TOTAL INCOME.	193,433	193,433
ADJUSTMENTS TO INCOME		
DEDUCTIBLE PART OF SELF-EMPLOYMENT TAX.	487	487
TOTAL ADJUSTMENTS.	487	487
ADJUSTED GROSS INCOME.	192,946	192,946
ITEMIZED DEDUCTIONS		
TAXES.	29,384	10,000
INTEREST.	13,754	13,754
CONTRIBUTIONS.	1,906	1,906
TOTAL ITEMIZED DEDUCTIONS.	45,044	25,660
TAX COMPUTATION		
STANDARD DEDUCTION.	12,600	24,000
LARGER OF ITEMIZED OR STANDARD DEDUCTION.	45,044	25,660
INCOME PRIOR TO EXEMPTION DEDUCTION.	147,902	167,286
EXEMPTION DEDUCTION.	16,200	0
TAXABLE INCOME.	131,702	167,286
TAX BEFORE CREDITS.	24,398	30,122
CREDITS		
TOTAL CREDITS.	0	0
TAX AFTER CREDITS.	24,398	30,122
OTHER TAXES		
SELF-EMPLOYMENT TAX.	973	973
TAX ON IRAS, OTHER QUAL. RET. PLANS, ETC.	40	40
TOTAL TAX.	25,411	31,135
Tax Increase (Decrease)		5,724

FEDERAL INCOME TAX SUMMARY

CLIENT SAMPLE2 BOB AND BETTY JONES

INCOME	2017	2018
WAGES, SALARIES, TIPS, ETC.	66,507	66,507
INTEREST INCOME.	892	892
BUSINESS INCOME.		
CAPITAL GAIN OR LOSS.		
FORM 4797 GAINS OR LOSSES.		
TAXABLE IRA DISTRIBUTIONS.		
RENT, ROYALTY, PARTNERSHIP, SCORP, TRUST.	401,631	401,631
TOTAL INCOME.	469,030	469,030
ADJUSTMENTS TO INCOME		
DOMESTIC PRODUCTION ACTIVITIES DEDUCTION	33,830	0
TOTAL ADJUSTMENTS.	33,830	0
ADJUSTED GROSS INCOME.	435,200	469,030
ITEMIZED DEDUCTIONS		
TAXES.	21,829	10,000
INTEREST.	0	
CONTRIBUTIONS.	63,927	63,927
DEDUCTIONS LIMITATIONS	(3,717)	
TOTAL ITEMIZED DEDUCTIONS.	82,039	73,927
TAX COMPUTATION		
STANDARD DEDUCTION.	12,600	24,000
LARGER OF ITEMIZED OR STANDARD DEDUCTION.	82,039	73,927
INCOME PRIOR TO EXEMPTION DEDUCTION.	353,161	395,103
EXEMPTION DEDUCTION.	0	0
TAXABLE INCOME.	353,161	395,103
TAX BEFORE CREDITS.	91,682	81,564
CREDITS		
TOTAL CREDITS.	0	0
TAX AFTER CREDITS.	91,682	81,564
OTHER TAXES		
SELF-EMPLOYMENT TAX.	0	973
TAX ON IRAS, OTHER QUAL. RET. PLANS, ETC.	34	40
TOTAL TAX.	91,716	82,577
Tax Increase (Decrease)		(9,139)

FEDERAL INCOME TAX SUMMARY

CLIENT SAMPLE3 JOHN AND JANE SMITH

INCOME	2017	2018
WAGES, SALARIES, TIPS, ETC.	45,656	45,656
INTEREST INCOME.	5,397	5,397
DIVIDEND INCOME.	47,773	47,773
CAPITAL GAIN OR LOSS.	27,244	27,244
FORM 4797 GAINS OR LOSSES.	34,324	34,324
TAXABLE IRA DISTRIBUTIONS.	830	830
RENT, ROYALTY, PARTNERSHIP, SCORP, TRUST.	2,969,088	2,969,088
TOTAL INCOME.	3,130,312	3,130,312
ADJUSTMENTS TO INCOME		
HEALTH SAVINGS ACCT	7,750	0
DOMESTIC PRODUCTION ACTIVITIES DEDUCTION	265,399	0
IRA	13,000	13,000
TOTAL ADJUSTMENTS.	286,149	13,000
ADJUSTED GROSS INCOME.	2,844,163	3,117,312
ITEMIZED DEDUCTIONS		
TAXES.	3,227	3,227
INTEREST.	255	255
CONTRIBUTIONS.	34,468	34,468
DEDUCTIONS LIMITATIONS	(30,156)	
TOTAL ITEMIZED DEDUCTIONS.	7,794	37,950
TAX COMPUTATION		
STANDARD DEDUCTION.	13,850	24,000
LARGER OF ITEMIZED OR STANDARD DEDUCTION.	13,850	37,950
INCOME PRIOR TO EXEMPTION DEDUCTION.	2,830,313	3,079,362
EXEMPTION DEDUCTION.	0	0
TAXABLE INCOME.	2,830,313	3,079,362
TAX BEFORE CREDITS.	1,056,044	1,124,455
CREDITS		
TOTAL CREDITS.	0	0
TAX AFTER CREDITS.	1,056,044	1,124,455
OTHER TAXES		
SELF-EMPLOYMENT TAX.	0	
TAX ON IRAS, OTHER QUAL. RET. PLANS, ETC.	4,678	4,678
TOTAL TAX.	1,060,722	1,129,133
Tax Increase (Decrease)		68,411